

CALIFORNIA STATE TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

---

SUBJECT: Fixed Income - Currency Hedging Policy

ITEM NUMBER: 7

ATTACHMENT(S): 2

ACTION: X

DATE OF MEETING: June 2, 1999

INFORMATION: \_\_\_\_\_

PRESENTER(S): Ms. Cunningham  
Mr. Hosokawa

---

**EXECUTIVE SUMMARY**

The California State Teachers' Retirement System (CalSTRS, System) has adopted a global investment strategy, which includes a 25% strategic allocation to non-dollar investments. Whereas domestic assets are exposed to market risk, which is the probability that financial assets will rise or fall in value, non-dollar assets have two sources of risk: 1) local market risk and, 2) currency risk. Since currency exchange rates are not stable, the likelihood that an exchange rate will remain constant over time is very small. It is this risk related to currency fluctuations that gives rise to currency strategies.

As described above, non-dollar investments are expected to represent a considerable portion of CalSTRS' investment portfolio. Furthermore, fifty percent (50%) of the non-dollar assets are targeted to be managed on a passive basis. Because the return associated with currency is a substantial component of the total rate of return of non-dollar investments, the currency strategy at CalSTRS could have a significant impact upon the total rate of return of the non-dollar investment portfolio. Therefore, in 1995, CalSTRS developed and implemented a Currency Hedging Program designed to reduce the risk of the passively managed segment of the non-dollar equity portfolio. As a result, controlled amounts of short currency positions are established in approved currencies when there is the risk that the U.S. dollar may strengthen.

One of the 1998/99 objectives approved for the Investment Branch is to review each of the policies to ensure completeness and consistency, with revisions to be made as necessary.

Attachment 1 represents the Currency Hedging Program Policy Manual, which outlines the policies of CalSTRS' Currency Hedging Program. This manual includes revisions to the previous Currency Hedging Program Policy Manual that was updated in January 1998. Most of the revisions represent changes in format and structure in order to be consistent with the other portfolios and programs managed within the Investment Branch.

These policies have been designed to address the System's philosophy with respect to the potential risk to the portfolio that currency represents and to clarify the role that currency hedging plays within the context of portfolio management. Also included is a flow chart in order to provide context for the policies within the general process of implementing the Currency Hedging Program. The policies are intended to be static in nature, and will be returned to the Investment Committee prior to changes being implemented.

## RECOMMENDATION

Staff recommends, and Pension Consulting Alliance concurs, that the Investment Committee approve the Currency Hedging Program Policy Manual by adopting the attached resolution. (Attachment 2)

# **CalSTRS**

## **CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM**

### **CURRENCY HEDGING PROGRAM POLICY MANUAL**

**INVESTMENT BRANCH**  
**June, 1999**

**California State Teachers' Retirement System  
Currency Hedging Program Policy Manual**

**TABLE OF CONTENTS**

Introduction.....	1
CalSTRS Currency Hedging Program Flowchart.....	2
CalSTRS Currency Hedging Program Policies.....	3
CalSTRS Currency Hedging Program Glossary.....	5

**California State Teachers' Retirement System  
Currency Hedging Program Policy Manual**

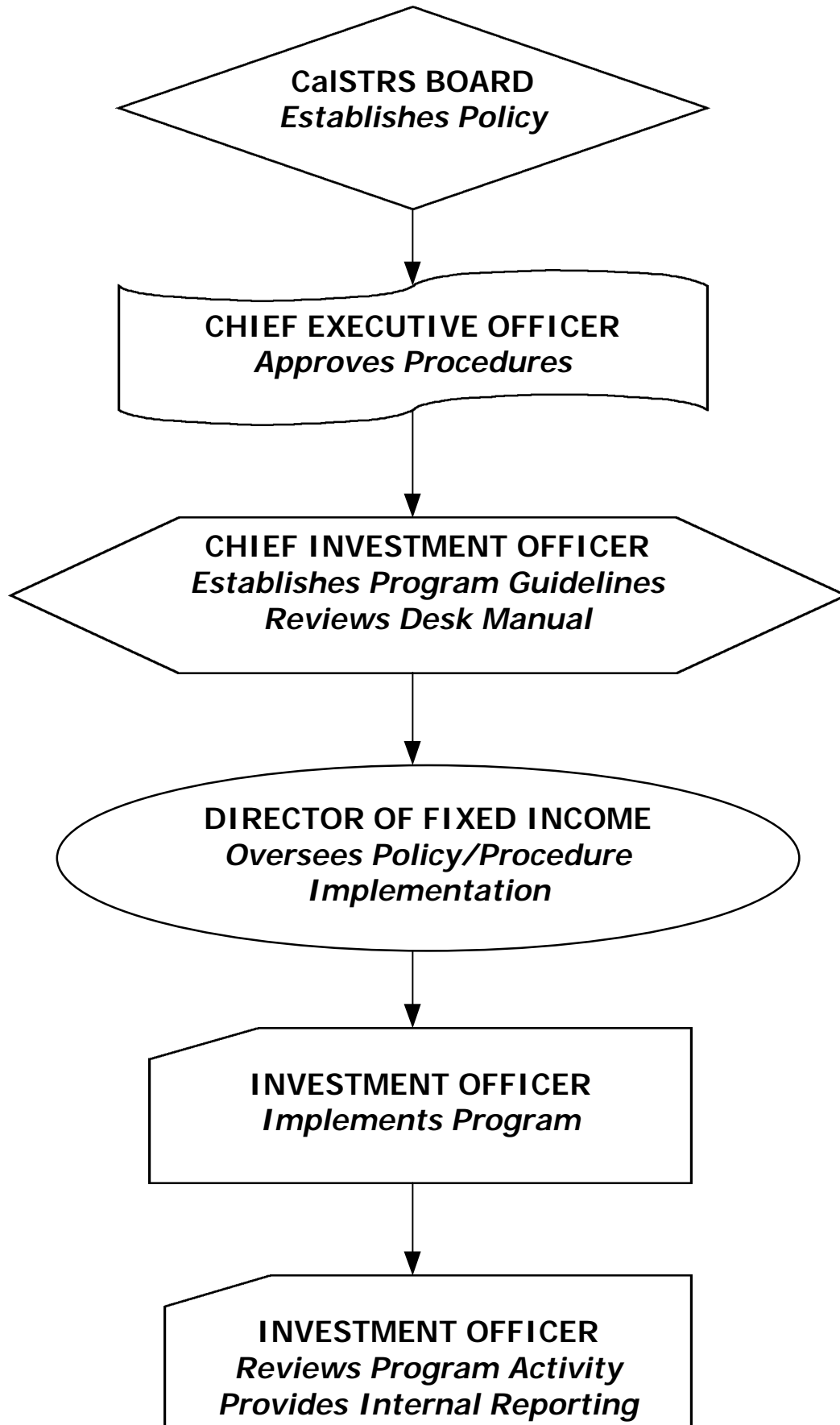
**INTRODUCTION**

The California State Teachers' Retirement System (CalSTRS, System) has adopted a global investment strategy, which includes a 25% strategic allocation to non-dollar investments. Whereas domestic assets are exposed to market risk, which is the probability that financial assets will rise or fall in value, non-dollar assets have two sources of risk: 1) local market risk and, 2) currency risk. For example, a portfolio of French assets may increase in value by 10% to a local (French) investor, but a U.S. investor, such as CalSTRS, would receive the 10% return plus or minus any change in the French franc to U.S. dollar currency valuation. Since currency exchange rates are not stable, the likelihood that an exchange rate will remain constant over time is very small. It is this risk relative to currency fluctuations that gives rise to currency strategies.

As described above, non-dollar investments are expected to represent a considerable portion of CalSTRS' investment portfolio. Furthermore, fifty percent (50%) of the non-dollar assets are targeted to be managed on a passive basis. Because the return associated with currency is a substantial component of the total rate of return of non-dollar investments, the currency strategy at CalSTRS could have a significant impact upon the total rate of return of the non-dollar investment portfolio. Therefore, in 1995, CalSTRS developed and implemented a Currency Hedging Program designed to reduce the risk of the passively managed segment of the non-dollar equity portfolio. As a result, controlled amounts of short currency positions are established in approved currencies when there is the risk that the U.S. dollar may strengthen.

This document outlines the approved policies of CalSTRS' Currency Hedging Program that have been designed to address the System's philosophy with respect to the potential risk to the portfolio that currency represents, and to clarify the role that currency hedging plays within the context of portfolio management. A flow chart is included to provide context for the policies within the general process of implementing the Currency Hedging Program. Words and terms that may be unfamiliar to the reader are referenced in the Glossary.

# CURRENCY HEDGING PROGRAM FLOWCHART



**California State Teachers' Retirement System  
Currency Hedging Program Policy Manual**

**CURRENCY HEDGING PROGRAM POLICIES**

**June 1999**

The following represent the approved policies to be utilized in the management of CalSTRS' Currency Hedging Program. They are designed to address the System's philosophy with respect to the potential risk to the portfolio that currency represents, and to clarify the role that currency hedging plays within the context of portfolio management. Policies approved by the CalSTRS Board cannot be altered without explicit approval from the CalSTRS Board.

1. **Laws and Statutes** - The Currency Hedging Program is to be managed in a prudent manner for the sole benefit of CalSTRS' participants and beneficiaries, in accordance with California State Teachers' Retirement Law and other applicable statutes.
2. **Program Objective** - The strategic objective for the Currency Hedging Program is to reduce the risk of the passively managed segment of the non-dollar equity portfolio by establishing controlled amounts of short currency positions in approved currencies when there is the risk that the U.S. dollar may strengthen. The performance of the Currency Hedging Program shall be evaluated in comparison to the MSCI EAFE Index on an unhedged basis.
3. **Counterparty Exposure** - A counterparty's inclusion within the Currency Hedging Program shall be evaluated, based upon the expertise and financial capacity of the firm. Due to the extended settlement practices, credit quality and size limitations will be established and documented within the Procedures Manual, and are subject to change as conditions warrant.
4. **Hedge Ratios** - Up to fifty-percent (50%) of the total market value of the passively managed segment of the non-dollar equity portfolio may be hedged. In addition, no more than one hundred-percent (100%) of each individual currency may be hedged. (No net short positions are permitted.) Any combination of approved countries can be utilized to reach the fifty-percent (50%) maximum limitation; however, no cross hedging is permitted.
5. **Approved Countries** - Given the substantial portion of the transactions and the market capitalization of the MSCI EAFE Index that they represent, the countries for which hedging currency exposure is permitted will be limited to those represented by the Euro (Germany, France, Spain, etc.), Japan, Switzerland and United Kingdom.
6. **Permitted Instruments** - Currency forwards, with a maximum value date of six months from the spot date, shall be utilized to establish the currency hedges. The use of currency futures, options on currencies, or options on currency futures is prohibited.

7. **Authorized Signers** – Authorization letters which indicate who may transact business for the CalSTRS Currency Hedging Program shall be sent with a copy of the most recent Currency Hedging Resolution, initially at the time an account is opened, and then periodically to all currency hedging counterparties with whom CalSTRS conducts business. Whenever a change in authorized signers takes place, the counterparties shall be notified in writing, within 24 hours in the event of termination, and as soon as possible in the event of a newly authorized signer(s).
8. **Authorization Limits** – The following daily limits apply with respect to the approval of currency hedging activity within the Currency Hedging Program:
- Investment Officer II - \$50 million
  - Investment Officer III - \$100 million
  - Director of Fixed Income - \$500 million
  - Chief Investment Officer - \$1 billion

Prior to being processed to Operations, all currency hedging tickets shall be authorized within these limits and countersigned by two Investment Officers.

9. **Business Plan** – The Currency Hedging Program will be managed in accordance with an annual Business Plan. This plan will include a broad overview of the Currency Hedging Program, with the key issues associated with the management of the program, as well as future objectives and a resource allocation analysis.
10. **Delegation of Authority** – The management of CalSTRS' Currency Hedging Program is delegated to staff within the boundaries established by these policies and the processes described within the Procedures Manual.
11. **Reporting** – Staff will prepare a report summarizing the activities associated with the management of the Currency Hedging Program on a monthly basis for the Chief Investment Officer. The report shall provide program information including outstanding positions, realized and unrealized gains/losses and a counterparty review.
12. **Board Review** – The Board shall administer and review this policy periodically, as it deems appropriate in keeping with the investment standard.



**California State Teachers' Retirement System  
Currency Hedging Program Policy Manual**

**GLOSSARY**

**APPROVED CURRENCIES** – The currencies of the countries where hedging exposure is permitted. The countries will be limited to those represented by the Euro, Japan, Switzerland and United Kingdom.

**CROSS-HEDGING** – Hedging the risk of one currency by buying or selling another currency. Because the different currencies are similar but not identical, additional risk may incur.

**COUNTERPARTY** – An individual or organization on the opposite side of a trade.

**CURRENCY** – Any form of money that is in public circulation.

**CURRENCY HEDGING** – A strategy used to offset the risk associated with holding non-dollar currency.

**CURRENCY RISK** – The risk related to currency fluctuations. For CalSTRS, it is the fluctuation of any foreign currency compared to the U.S. dollar.

**EXTENDED SETTLEMENT PRACTICES** – Settlement for currency forwards takes place on the value date. Value dates for CalSTRS Currency Hedging Program are limited to the one to six month area.

**HEDGE RATIOS** – The number of currency forwards sold against a position in the underlying currency in order to hedge the position.

**MSCI EAFE INDEX** – The Morgan Stanley Capital International Europe, Australia & Far East Index.

**NON-DOLLAR** – Investments made in currencies other than the U.S. dollar.

**PRUDENT MANNER** – The fiduciary is required to act in a manner appropriate in keeping with the investment standard, in the best interest and for the sole benefit of CalSTRS' participants and beneficiaries.

**SHORT CURRENCY POSITION** – The act of selling currency in which the seller does not have an underlying position.

**VALUE DATE** – Term used in relation to foreign currency to indicate the date when transferred money becomes available to the depositor.

PROPOSED  
RESOLUTION OF THE  
CALIFORNIA STATE TEACHERS' RETIREMENT BOARD  
INVESTMENT COMMITTEE

SUBJECT: Currency Hedging Program Policies

Resolution No. \_\_\_\_\_

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the Investment Committee has received and reviewed the Currency Hedging Program Policies and has heard oral presentations from Staff; and

WHEREAS, the Staff has recommended the adoption of the Currency Hedging Program Policies; Therefore be it

RESOLVED, that the Investment Committee of the California State Teachers' Retirement Board adopts the Currency Hedging Program Policies.

Adopted by:  
Investment Committee

On \_\_\_\_\_

\_\_\_\_\_  
James D. Mosman  
Chief Executive Officer